BMO Wealth Institute™

/Report
CANADIAN EDITION

Retirement planning: Can I get back to you on that?

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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Executive summary

Canadians have a good understanding of what they should be doing to ready themselves for retirement, but they are not so good at following through.

In a survey of Canadians over the age of 35, The BMO Wealth Institute found that people tend to put off planning and saving for retirement, even though they realize that getting an early start will allow them to live a desirable lifestyle in retirement. The Institute examines the competing priorities that put us off course.

Some of the obstacles, however, are psychological. The Institute explores some of the reasons why people tend to procrastinate, drawing upon the findings of a growing field of research called behavioural finance. A variety of cognitive biases can affect people's decision-making, sometimes with negative consequences. By recognizing the symptoms, Canadians may be able to adjust their behaviour and get their retirement planning process back on track.

Achieving a desired retirement lifestyle

Many Canadians are not planning or saving adequately for their retirement – or, at least, not if they seek to live a lifestyle in retirement that is comparable to their working years. For example, about two-thirds of Canadian tax filers fail to make contributions to Registered Retirement Savings Plans (RRSPs)[1] – and even among those who do, fewer than 30 per cent make contributions year after year[2]. It is estimated that Canadian taxpayers have accumulated about $624 billion in unused RRSP contribution room[3] – money that could be collecting investment returns to fund their future retirement.

How do we explain this phenomenon? Is it because Canadians don't realize they need to have a plan? Is it because they don't have the means to save more money? Or is there some other explanation?

The BMO Wealth Institute (The Institute) set out to find some answers in the hope that a better understanding of the behavioural tendencies that prevent people from preparing for their retirement will help others make more informed choices during their working years – so they can live the lifestyle they desire when they retire.

Maybe they just don't realize...

Why are so many Canadians not planning and saving adequately for their retirement? One possibility is that they simply haven't got around to it yet and/or don't really know how much they need to save.

In a survey commissioned by The Institute[4], Canadians not yet retired were asked how satisfied they were with the amount they had saved for retirement. Among savers, only a slim majority indicated they were "somewhat satisfied" with the amount they were saving, and nearly four in ten expressed dissatisfaction. About half of the non-retirees in the sample reported that they expect to live a lifestyle in retirement that is less, or much less, comfortable than their current lifestyle. And nearly seven in ten non-retirees expressed concerns about recent and current economic conditions and the impact these may have on their financial security down the road. There would appear to be no lack of awareness among Canadians of the challenges they may face in retirement.

The respondents were also aware of the steps they should be taking to prepare for retirement, and almost nine in ten reported that such planning should begin before age 35.

But "knowing" something and acting on that knowledge are two different things.

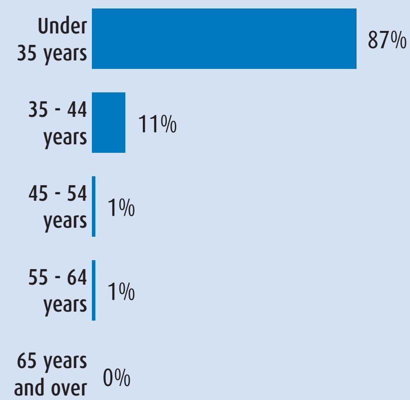
Thirty-nine per cent of non-retirees in the survey conceded they had done no planning to ensure they had enough money for retirement – and even of those who had begun to plan, only half had started before age 35.

While the importance of a household budget was widely acknowledged, nearly half of the sample did not have one. Almost four in ten households reported that they spend more than they should – and among non-retirees with debt, more than one in five (21 per cent) reported they "worry a lot" about current debt levels.

So, if lack of knowledge doesn't explain their failure to take the right steps to secure their future, how does one explain it?

The Institute turned to the world of behavioural finance to find the answer.

At what age do you feel people should start planning for their retirement?



Source: Behavioural Finance and Retirement Planning Survey, BMO Wealth Institute, June 2010.

Psychology meets finance

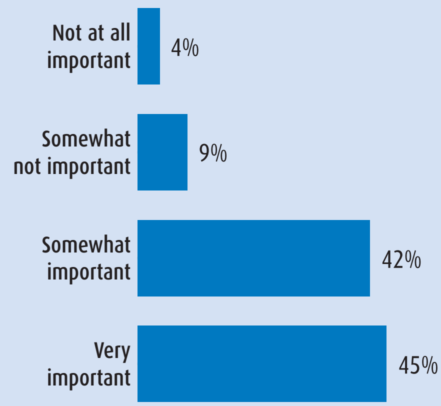
Behavioural finance (or behavioural economics) was developed to respond to the shortcomings of traditional economic theory. Classical economics is based on the idea of "Homo Economicus" or Economic Man – that a wholly rational being who analyses all the options and makes only those decisions that will advance his self-interest the most.

"Economic Man is a marvellously convenient pawn for building academic theories," wrote Craig Lambert, deputy editor of Harvard Magazine. "But Economic Man has one fatal flaw: he does not exist."[5]

Real human beings often act irrationally, making choices that Economic Man would turn down flat. Enter the behavioural economists who study the behaviour of real human beings and try to determine if there is some underlying pattern to the way they act.

The implications of this field of study are becoming increasingly relevant for retirement planning as the responsibility for managing retirement savings shifts away from the "organization" to the individual – a trend that is accelerating as employers move from defined benefit (DB) pension plans to defined contribution (DC) plans. In DC plans, where one makes one's own investment choices, the human element is the critical variable in the success of the investment program, and human shortcomings like procrastination can have a direct bearing on one's lifestyle options down the road.

How important is a household budget?



Source: Behavioural Finance and Retirement Planning Survey, BMO Wealth Institute, June 2010.

Prospect Theory: a core theory in behavioural finance

Researchers in behavioural finance have developed various theories to explain why our behaviour sometimes appears less than rational. They include concepts such as Prospect Theory[6], which has shown that the relative value of choices may not be as important as how those choices are framed.

Two outcomes may be identical, but the way they are expressed, or framed, can produce different responses. For instance, individuals may be content to imagine needing to spend only 70 per cent of their current income in retirement, but they are far less comfortable with the prospect of being forced to trim 30 per cent of their current expenditures – even though the two statements are equivalent.

Prospect theory also assumes "loss aversion" which argues that people judge a loss of x to be more significant than – perhaps twice as large as – a gain of equal value. By way of illustration, if a gamble with 50-50 odds (e.g., a flip of a coin) could result in a $100 loss, research shows that individuals would typically be willing to take that gamble only if the prize for winning were $200-$250[7].

Loss aversion has a direct bearing on retirement planning. A decision to contribute to a retirement savings plan requires some reduction or "loss" today, and individuals tend to be reluctant to give up something today, even if there is a potential future gain.

Mental shortcuts can lead astray

Behavioural economists also focus on the mental shortcuts that people use when making decisions. On the one hand, these shortcuts, based on a lifetime of experience, can be helpful because they allow us to make quick, instinctual decisions rather than get bogged down in analysis. However, these heuristics (to use the researchers' term) can also produce biases that skew people's decisions in the wrong direction.

Some of the biases that can affect financial decision-making include:

Hyperbolic Discounting[8]: This is a version of "a bird in the hand is worth two in the bush." People tend to place less value on a reward in the future than a benefit today. This tendency to discount the future benefit encourages procrastination and explains in part why people use credit cards (for immediate gratification) yet fail to save for retirement (a benefit in the future).

Canadians understand they should be saving for retirement, but in the Institute survey, non-retirees who hadn't started saving, or hadn't saved recently, said they were more concerned about current needs. More than four in ten non-retirees conceded that they know they spend more than they should, but they wanted the "good things in life for me and my family." And more than one in four agreed with the sentiment that one should "eat, drink and be merry" because one may not live to a ripe old age.

Paralysis of choice[9]: More is not always better when it comes to decision-making. Researchers have demonstrated that people faced with too many choices may simply become paralysed and make no choice at all.

In The Institute's own study, more than one-third of non-retirees surveyed reported that they have been overwhelmed by too much information, and that this has been an obstacle or challenge to their retirement savings plans.

Vividness[10]: It is hard to imagine events in the future – let alone events 20 or 30 years down the road. When making choices that will yield results only at a much later date, such as saving for retirement, people tend to behave differently depending on how vivid their picture of that future state may be. If individuals cannot picture themselves as retirees, they find it difficult to sacrifice things today for that uncertain future. If, on the other hand, they have a vivid picture of themselves in the future, they are more likely to provide for their future selves.

The curse of knowledge[11]: People who know a lot sometimes find it hard to imagine how little others know. This bias makes it hard to understand perspectives that are not based on the same level of knowledge – a recurring problem for teachers, but something to which anyone who provides advice can be prone, including financial advisors who need to remind themselves, perhaps, when their clients hesitate to make an "obvious" financial decision, that they should not be expected to have the same level of knowledge or experience as the advisor.

Other priorities intrude

While these biases may affect the way people make decisions, their individual circumstances will have a direct bearing, too. When people are asked why they don't start saving earlier or saving more for retirement, the response often given is that they don't have the money. So, what are they spending their money on? What is taking a higher priority over saving for retirement?

The findings of The Institute's study reveal that planning and saving for retirement are strongly influenced by three variables – age, the presence of children in the household and income.

Those between 35 and 44 years of age, those with children in the household (particularly children under the age of 18), and those with annual household incomes of under $80,000 are less likely to be involved in planning for retirement and less likely to be saving for retirement. While they recognize the value of planning and saving, it is not their priority. They are consumed by other priorities, including debt reduction and managing current expenses.

The "spending" years

The Institute survey confirmed that people in the age bracket 35 to 44 are most likely to overspend, to have debt and worry about it, and are the furthest behind on planning and saving for retirement. Not surprisingly, therefore, people in this age group are also the most likely to be dissatisfied with the amount they have saved for retirement.

Clearly, this age bracket represents a period when people are buying houses, paying mortgages and raising children, and the thought of diverting funds to retirement takes back seat. Yet it is also a crucial period of wealth accumulation – a stage of life still far enough away from retirement to permit the magic of compound interest to play its role.

Raising "Junior"

The presence of children under 18 is among the strongest predictors of behaviours. Since most people with children under the age of 18 are in the 35 – 44 age group, it is not surprising that there are a lot of similarities in the survey results between these two groups.

While those with children under 18 are among the most likely to have a monthly budget, they are also among the most likely to have debt (especially mortgage debt) and to overspend. They are also more concerned about their debt and worry more about the implications of recent economic circumstances.

They are among the least likely to view retirement savings as a priority for them today. Instead, their priority is debt reduction. As a result, they are the least likely to have started the process of retirement planning, they are behind on all of the things one needs to do to prepare for retirement (i.e., invest in RRSPs, TFSAs, etc.), and they are among the most dissatisfied with the level of savings they have accumulated for retirement.

As society changes and people wait later in life to raise children, there is a risk that this decade of "inattention" or distraction will take place later in life too – pushing back the time when they finally get serious about saving for retirement. This could shorten their time horizons for retirement planning and, ultimately, have an impact on the success of their retirement saving efforts.

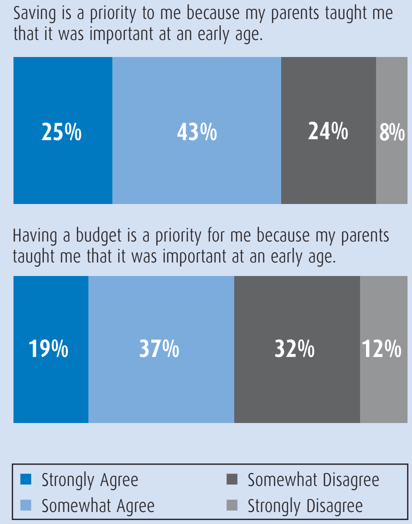
Can I afford to save?

The third variable strongly related to retirement planning and saving is, perhaps not surprisingly, income. There is a clear and significant divide between those in the lowest household income category ($40,000 to $80,000 in The Institute's survey) and the highest ($120,000+).

When it comes to retirement planning, savings and expectations, lower income respondents registered the weakest scores. They are least likely to describe saving for retirement as a top priority, least likely to have done retirement planning, most dissatisfied with the amount they have saved, and most likely to report that they will be less financially comfortable in retirement than they are today.

Lower income respondents also expressed less confidence in their ability to prepare for retirement. They are more likely to say that they lack understanding of investments, including pension plans, RRSPs and other retirement savings accounts, more likely to be overwhelmed by too much information and more likely to be uncertain about where to begin.

When Asked: To what extent do you agree or disagree with the following statements?



Source: Behavioural Finance and Retirement Planning Survey, BMO Wealth Institute, June 2010.

Father (Mother) knows best...

In its study, The Institute sought additional information about where people should go to learn about personal finance – a topic particularly relevant now as governments at all levels grapple with the issue of financial literacy.

The vast majority of survey participants believed that children's attitudes toward budgeting and saving will be influenced by their parents' behaviour – which is natural, since nearly seven in ten respondents reported that their own saving habits had been influenced by their parents and slightly over half said they were taught to budget by their parents. In some cases, the respondents said they were influenced in a different sense – namely, by a desire to avoid making the same mistakes as their parents – but they were influenced, all the same.

Overwhelmingly, the respondents in The Institute's study agreed that it is important to teach children at an early age to budget and save. While they appreciated that the school system has a role to play, almost nine in ten respondents believed that teaching children about personal finances is a parental responsibility.

It seems safe to conclude that the next generation will be influenced by the behaviour of their parents, too. What lesson will the parents be teaching when they put off retirement planning?

It's never too soon

More than eight in ten survey respondents agreed that Canadians should begin retirement planning and saving as early as possible. Starting in one's 20s is not too soon.

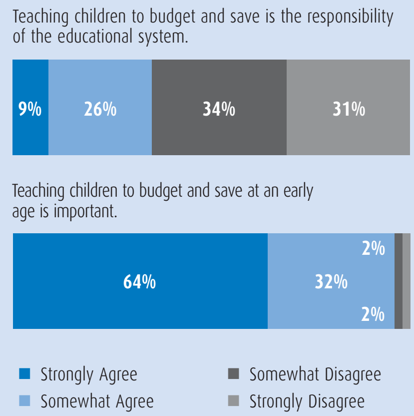
As they enter the regular workforce and start getting a full-time pay cheque for the first time in their lives, young adults in their 20s will suddenly find themselves with more disposable income than they have ever known. This is a good time to begin thinking about the future. For example, it is never too early for young adults to learn about Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs) and to begin making regular contributions to them. However, the proportion of younger people (age 25 to 45) making RRSP contributions has steadily declined over the past ten years[12].

An automatic savings program is also desirable – where a percentage of one's pay cheque is tucked away before one sees it. Behavioural studies prove time and again that people are more likely to meet their savings goals, if their savings account is not readily accessible.

The payoff for starting to save early is substantial. The 25-year-old[13] who puts aside $500 per month for 20 years (for a total of $120,000), and not a penny more, will wind up with 33 per cent more savings at age 65 than the 45-year-old[14] who puts aside $1,000 per month for 20 years (for a total of $240,000). Such is the power of compounding – the strongest argument there is for starting to save early.

Power of Compounding				
Age	Monthly Contribution	Savings Period	Total Amount Contributed	Ending Value at Age 65
25	$500	20 years	$120,000	$540,448
45	$1,000	20 years	$240,000	$407,378

When Asked: To what extent do you agree or disagree with the following statements?



Source: Behavioural Finance and Retirement Planning Survey, BMO Wealth Institute, June 2010.

At the start of one's working life is also the time to investigate an employer's pension offering and sign up for it. In addition, if the employer offers a share ownership plan or a profit-sharing plan, it would be wise to find out about them and take advantage of such savings vehicles.

It is much easier at an early stage in life to establish healthy budgeting habits and a savings discipline than it is later on. As The Institute's study showed, by the time people reach their mid-30s, they may be facing too many competing priorities. Another benefit is that as these young adults get older and form families of their own, they will be positive role models for the next generation.

Learning from others

For those Canadians closer to retirement, it makes sense to listen to the advice of people who are already there. That said, retirees and non-retirees alike agree on many things – including the importance of starting to save early, living within your means, and developing a retirement plan that includes specific savings goals. Nearly nine in ten non-retirees in The Institute's study, agreed that it would make a big difference over time if they were to start setting aside a modest amount every month for retirement savings. They understood that it makes sense to establish a regular savings program and to make full use of RRSPs, TFSAs or other tax-advantaged investment vehicles – all of which are actions that retirees heartily endorsed.

Where retirees and non-retirees differed, however, was in their perceived need to seek help in retirement planning. When people already in retirement were asked their views about retirement planning, nearly eight in ten reported that they were not able to do it themselves, or that they needed help. By contrast, more non-retirees reported that "I can do this by myself," than reported that they needed help.[15]

People of every age can benefit from financial advice. Parents play a role by teaching children basic money management skills, and helping themdevelop good budgeting and saving behaviours. Indeed, parents' own financial behaviours have immense influence on their children. Being a good role model sows the seeds of healthy financial behaviour early on. As young adults set out on their own, they can begin to broaden their sources of advice. It is never too early to seek out advice that might give one a head start on planning and saving – before other priorities begin to intrude. At any point, if finding it difficult to save, it is important to examine one's spending patterns carefully. A financial advisor can assess individual circumstances and help one set priorities, determine what's affordable and build a realistic, manageable savings program that is easy to maintain.

All the while, it will require a conscious effort to overcome all the human foibles catalogued by the behavioural economists. Employers, governments and financial institutions can help people deal with these issues by finding ways to motivate the desirable behaviours: budgeting, planning and saving.

In the end, however, Canadians themselves need to take charge of their own retirement. It is important to understand that the decisions that people make before retirement will affect their lifestyles for a period that could potentially last longer than their entire working careers, and it is never too late to start planning for retirement.

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13 Assumption: Constant monthly investment of $500 from age 25 to 45 (for a total savings amount of $120,000) to an RRSP; compounding rate of return of 5%; ending value of the investment at age 65 is $540,448.
14 Assumption: Constant monthly investment of $1,000 from age 45 to 65 (for a total savings amount of $240,000) to an RRSP; compounding rate of return of 5%; ending value of the investment at age 65 is $407,378.

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